

# Negotiating the UK's post-Brexit trade arrangements

Peter Holmes, Jim Rollo and L Alan Winters<sup>1</sup>

Whatever 'Brexit' comes to mean, it will inevitably entail a major reset of the UK's trade relations. Among the things that need to be achieved are:

- extracting UK WTO schedules from EU Schedules and re-setting relations with the non-EU members of the multilateral trading system;
- negotiating a new trading relationship with the remaining 27 members of the EU;
- designing and agreeing our future trade relations with Least Developed Countries and other developing countries covered by the EU's General System of Preferences (GSP); and
- agreeing trade deals with other countries, including those with which the UK already has deals via the EU, those with which the EU has agreed but not ratified a deal, those with which the EU is currently negotiating and other potential trade partners.

The scale and complexity of this task is unprecedented and even if most existing agreements were merely rubber-stamped and continued, the demands for diplomatic and negotiating resources are massive. The UK will need to engage with the remaining 163 WTO Members (27 of which will be EU Member States). Beyond this, following DG Trade's classification of bilateral and regional trade relationships, there are 148 potential negotiations facing the UK.<sup>2</sup> Of these 92 are with countries in receipt of unilateral GSP preferences that the UK can continue after Brexit. If these countries require no further attention (not a sure thing), there still remain 56 potentially live negotiations. As a benchmark, the European Commission is currently engaged in 10 active trade negotiations. Some tasks would need to be done simultaneously but achieving the whole will require careful sequencing and prioritisation. We argue that the process has to start with the WTO and the EU.

Brexit gives the UK a chance to re-think the basis of UK trade policy and pursue a UK-specific vision. However, the workload and time pressure that even a least-change version of Brexit entails suggest that deciding, let alone negotiating, a completely new regime is unrealistic. Thus while in due course we might hope for some radical changes, we do not expect them over the next few years.

## *What Trade Negotiations Entail*

In history, trade negotiations have revolved around reciprocal market access, with both sides aiming to maximise access for their exporters while continuing to protect sensitive industries at home. Yet recent trade agreements have pursued deeper

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<sup>1</sup> Respectively, Fellow, Deputy Director and Director of the UK Trade Policy Observatory (UKTPO); University of Sussex. Other members of UKTPO have contributed substantially to the analysis within this paper and we are appropriately grateful to them for doing so.

<sup>2</sup> [http://trade.ec.europa.eu/doclib/docs/2006/december/tradoc\\_118238.pdf](http://trade.ec.europa.eu/doclib/docs/2006/december/tradoc_118238.pdf) . Some countries figure individually and as members of a group in this list.

economic integration and cooperation, not just for goods but also, critically for the UK, services and investment, and harmonisation of regulations and standards to facilitate free movement in a world where markets are increasingly interconnected. The European Single Market gives unprecedentedly deep integration in these dimensions with EU partners, and to avoid a major trade-crunch British negotiators will have to address them both in Europe and with the other partners which the Brexiteers hoped would provide alternative markets.

The major economic benefits from trade come from opening up domestic markets to imports. Lower prices, higher quality, new products and technologies all benefit both consumers and producers, although opening markets also creates 'losers' and thus generates political resistance at home. This means that trade negotiators have to negotiate with vested domestic interests as well as foreign governments. It is this two-level game, as Putnam characterised it, which has to be played out on both sides that makes trade negotiations so sensitive and protracted<sup>3</sup>. Thus if the UK exposes its markets to more import competition, it also needs to be ready to help disadvantaged groups at home adjust, drawing on tools such as delayed implementation in sensitive/declining sectors, retraining for workers who lose their jobs, regional aids to encourage new investment in areas hit hardest by the competitive challenge, and short and long term compensation beyond standard social security.

Table 1 reports on the UK's ten largest trade partners defined in terms of exports of goods and services. Block A gives the data on goods *and* services trade, but at the expense of referring only to 2011. Block B refers to goods alone but for an average over 2013-2015. The table shows the predominance of the EU as a market and a supplier, accounting for approximately half of both goods and services imports and exports. Next comes the USA, but with about a quarter to a third of the volume of trade with the EU, followed by China which supplies far more imports than it takes exports and India of which the opposite is true. Australia and Canada both figure in the goods and services list but barely for goods alone, because they are more important in services than in goods. In goods alone, exports to Switzerland are dominated by gold and imports from Russia and Norway by oil.

These data hint at the magnitude of the task facing UK trade negotiators. To compensate for a 1 percent reduction in exports to the EU because of reduced market access, exports to the USA, for example, would have to increase by nearly 4 percent. Increasing exports to Switzerland, which are mainly gold, a product the UK barely produces, is not a long-run strategy. Even trade with Canada, ranked fourth among non-EU partners, is tiny compared with that with the EU and it is heavily focussed on services (as is Australia's trade). Services trade liberalisation is inherently more difficult than goods liberalisation, as it can entail conflict with domestic public policy objectives (especially in health and education). Yet services are the area in which the UK specialises. Focusing on goods alone would divert attention from the largest barriers to UK trade and its most dynamic area of growth. It would also risk serious damage to the core of the UK economy by encouraging the flight of service providers.

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<sup>3</sup> Putnam, R. D. (1988). Diplomacy and domestic politics: the logic of two-level games. *International organization*, 42(03), 427-460.

Table 1: The UK's trade with its main trading partners, 2011 and 2013-15

	Block A Goods and Services, 2011				Block B Goods only, average 2013-15			
Partner	Exports	Export	Imports	Import	Exports	Export	Imports	Import
	(\$billion)	Share %	(\$billion)	Share %	(\$billion)	Share %	(\$billion)	Share %
EU28	347.1	47.0	389.4	49.9	226.7	45.1	350.9	53.8
USA	109.4	14.8	88.5	11.4	64.2	12.9	57.1	8.8
China	26.2	3.5	58.4	7.5	23.9	4.8	61.6	9.4
India	19.0	2.6	24.8	3.2	6.7	1.3	9.9	1.5
Canada	18.4	2.5	13.3	1.7	6.5	1.3	13.1	2.0
Australia	16.7	2.3	7.7	1.0	5.8	1.2	3.2	0.5
Japan	16.4	2.2	17.1	2.2	6.9	1.4	10.6	1.6
Russia	15.1	2.0	14.1	1.8	5.4	1.1	9.1	1.4
Switzerland	13.7	1.9	8.7	1.1	46.0	9.0	10.4	1.6
Norway	10.5	1.4	46.1	5.9	5.3	1.1	24.1	3.7
Rest of World	146.2	19.8	111.8	14.3	105.6	21.0	102.9	15.8
Total	738.7	100.0	779.9	100.0	503.1	100.0	652.9	100.0

Sources: Block A from the Trade in Value Added (TiVA) Dataset -

<http://www.oecd.org/sti/ind/measuringtradeinvalue-addedanoecd-wtojointinitiative.htm> ;

Block B is based on UN Comtrade Data extracted using TradeSift software (www.tradesift.com)

## Prioritising Targets for Negotiation

- Negotiations with the WTO and the EU are the two most important in nature and the most pressing in time.

Establishing these new relationships is crucial to re-setting existing trade arrangements and exploring new trade opportunities elsewhere. The EU-UK trade relationship will shape the objectives of the rest of the world in trade with the UK, and it is hard to see how negotiations with third parties can conclude until new arrangements with the WTO are in place, since only then can they be clear about the baseline from which to measure the value of any preferences in the UK market.

The UK fairly much has to pursue negotiations in the WTO and the EU simultaneously, so that on the day after Brexit it is ready to start serious and informed negotiations with other partners. It seems inevitable that there will be major changes in trading conditions with the EU and so our advice is that the UK should initially seek to minimise the changes that it makes to its tariff schedules and other conditions in the WTO. It can then return to renegotiate these when other elements of the constellation are in place. The problem is that this may not be easy. We start, however, with the EU.

## *The EU27*

The Brexit campaign stressed three things: curbing immigration from Europe, regaining control of regulations and trade policy, and cutting UK payments into the EU budget. There has been little discussion of the last, so it may not be a binding constraint, but politics would seem to dictate that the other two must be addressed. Curbing immigration violates the principle of free mobility of labour within the EU

and seems very likely to lead the EU27 to refuse the UK full access to the European Single Market on current terms – as it threatens to do to Switzerland if the latter curtails labour mobility. Regaining control of our trade policy rules out UK continued membership of the European Customs Union (CU), or indeed signing a Customs Union agreement as Turkey has done with the EU, because CU members are, by definition, required to have a common trade policy. This leads us to believe that the most trade-enhancing outcome of Brexit is a free trade area (FTA), which allows tariff-free movement of goods between the UK and the EU27 but potentially different tariffs on imports from third countries, coupled with agreements covering both the mutual recognition of standards for trade in some goods and services (i.e. effectively membership of the Single Market for specific sectors or activities).<sup>4</sup>

### *Free Trade Areas and Rules of Origin*

The critical difference between a CU and an FTA is that whereas the former allows goods, once inside the area, to circulate without facing any additional tariffs because they will have faced the same tariff wherever they entered the area, the latter cannot do this. If one member of an FTA has a zero tariff on, say, oranges, while others have positive tariffs, exporters would seek to send their oranges to the first country and serve the others from there, thus avoiding the other members' tariffs. To avoid this trade deflection, FTAs have rules of origin (RoOs) to determine whether a good has been produced within a member country, in which case it is exempt from tariffs under the FTA agreement, or whether it has been produced outside, in which case it has to pay the tariff of the country of destination.

Applying a RoO is straight-forward for simple goods like oranges, but most manufactured goods are produced by combining many inputs, some of which may come from third countries. In these cases, the RoOs can be complex, but typically a product needs to contain 60% local value added to be eligible for duty free import into the EU under the European Economic Area agreement and we might anticipate the same for the UK. Enforcing such RoOs means customs checks of some kind between the EU and the UK even in an FTA. These could be minimal if electronic documentation can be used but they would give French customs at Calais the right to inspect UK trucks to ensure that the RoOs are satisfied. All this adds cost, delay and uncertainty to the trading relationship. A major concern, especially if one is hoping that the UK economy will respond to Brexit in a flexible and innovative way, is that, while for large companies the cost of establishing origin is mainly a fixed cost which can be spread over a large volume of sales, for small, and even more so, one-off, exporters the bureaucratic costs can be proportionately very high – even prohibitive.

### *'Regulatory Unions'*

For the sectors that are not granted conditions equivalent to the Single Market similar problems arise with standards and the certification process by which conformity to standards is checked. The EU is not only a Customs Union but also a 'regulatory union', which means that all members incorporate EU mandatory standards into their legislation, along with the rules for establishing conformity with the rules. Hence

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<sup>4</sup> At the time of writing – late September – the government has given no indication of its thinking even on the broadest parameters of its trade strategy.

products produced within the EU can be assumed to conform to mandatory standards and can circulate without further inspection to any other part of the EU. At present, for the French authorities to stop a UK lorry at Calais to check that its contents met EU standards would be legally equivalent of stopping a lorry passing from Kent to Sussex for that purpose – that is, a gross violation of the right of citizens to trade with each other. If the UK were outside the Single Market, however, such inspections could not be ruled out, absent an agreement specifically to that effect. And in order to sell in the EU the UK trader would have to have her product checked by an officially accredited agency, which status is, in the EU, probably restricted to EU agencies<sup>5</sup>. This brings further cost, delay and uncertainty.

In services, the absence of a regulatory agreement could prevent cross-border trade altogether. The most discussed case of this is the so-called passport for financial services firms. This allows a firm established in one EU country to sell services in any other EU country without establishing there. In this sector establishment entails being regulated by the local authorities which means not only preparing all sorts of documentation and accounts, but meeting local prudential capital requirements. These typically require a minimal level of assets to be held and the fragmentation of doing this in several places instead of just one is a major cost; moreover aggregating activities over several locations allows a much freer movement of funds across borders and hence more efficient financial operations.

It will be possible to negotiate approximations to single-market arrangements sector by sector, as indeed the Swiss have done, but it will be a major operation. Moreover, our guess is that if the UK curbs inflows of labour, it will be permitted to do so in only a subset of service sectors at best. An interesting and important issue will be which sectors the UK government chooses to favour in this way, especially given the intensive lobbying that we see (and presumably much that we don't see) from various sectors – e.g. Motor cars, financial services and pharmaceuticals.

### *Relative UK and EU Negotiating Strength*

It is often argued – sometimes from very senior positions - that because the EU exports more to the UK than the UK exports to the EU, the EU will be keener to strike a free trade agreement and therefore more accommodating in negotiations. This is seriously misguided. While 45% of UK exports go to the EU, an average of 6.7% of EU countries' exports go to the UK<sup>6</sup>. In other words, while the average UK exporter faces disruption to 45% of its exports the average EU exporter faces problems with 6.7% of its exports. Who is going to suffer the bigger disruption and need a deal more?

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<sup>5</sup> There is in fact some uncertainty about whether the inspection has to be done by an agency located in the EU: Richard North argues that certification would be problematic (<http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/the-uks-future-economic-relationship-with-the-european-union/oral/35137.html>), while Andrew Chapman argues that it would be easy (<http://doortofreedom.uk/technical-barriers-to-trade-in-the-absence-of-a-mutual-recognition-agreement>).

<sup>6</sup> These data refer to exports to UK as a share of EU members' total exports, 2013-15. Data from TradeSift, 5<sup>th</sup> October 2016. Expressed as a share of extra-EU exports the figure would be around 16 percent. Every single member of the EU has to agree to a trade deal, so the statistic for the individual countries is more relevant than the extra-EU one.

### *The European Economic Area (EEA)*

One proposal has been that the UK could circumvent these difficulties by joining the European Economic Area (EEA), thus obtaining Single Market conditions across the board. We do not see this as a likely solution. The EEA formally consists of the EU plus three members of EFTA (Norway, Liechtenstein and Iceland). The latter become part of the EU “regulatory union”: they have to adopt all EU legislation in the covered sectors (all goods and services except agriculture and fisheries), including free movement of labour and with no say on them, but in return get access to the whole Single Market free of all technical barriers. The “regulatory union” also implies, however, that individual members cannot sign agreements with third countries that affect technical regulations.

But membership of the EEA does not mean that there are no barriers. Being a Free Trade Agreement rather than a customs union, the EEA needs Rules of Origin. Duty-free circulation applies only to goods ‘originating’ in member states. For example a Toyota car that had more than 40% of its components imported from outside the EU would not be considered a UK car and would have to pay the EU’s MFN tariff to enter. This would be very unattractive to foreign investors, as the comments from Carlos Ghosn, Chief Executive of Nissan on 29<sup>th</sup> September demonstrated.<sup>7</sup>

### *Article 50 and the Timing of Negotiations*

The key objective with the EU should be to start discussions on the future trade relations as soon as possible. The content of Article 50 negotiations and the role of trade negotiations in the exit process are actually ambiguous.<sup>8</sup> One interpretation suggests that negotiations on trade cannot begin until after Brexit<sup>9</sup>, but a more forgiving interpretation can be drawn from Article 50(2), which states that an exit agreement should take ‘account of the framework for its future relationship with the Union’. This seems to include the possibility of trade negotiations taking place in parallel to, or as part of Article 50. This is, however, a slender hook on which to hang our hopes and the EU 27 may refuse to play ball. Moreover, we have to recognise that while the Article 50 negotiation is effectively time-limited and approved in the EU27 by qualified majority vote, a trade agreement is not so constrained and requires unanimity among EU Member States. On the precedent recently established for the FTA with Canada, the latter seems likely to entail approval by up to 38 different European parliaments.

- It would be convenient if the UK could agree a “peace clause” with the EU that allowed trade to continue based on existing procedures while the long term agreement is negotiated.

However, such a clause could be challenged in the WTO because it would give the UK and the EU preferential access to each other’s markets while not constituting a

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<sup>7</sup> <https://www.theguardian.com/business/2016/sep/30/nissan-hard-brexite-compensation-new-uk-investment-tariffs>

<sup>8</sup> See Lydgate, UKTPO blog 2016 (<http://www.sussex.ac.uk/eu/articles/brexit-delay>)

<sup>9</sup> Cecilia Malmstrom interview BBC 30 June 2016  
<http://www.bbc.co.uk/news/uk-politics-eu-referendum-36678222>

customs union or free trade area as defined by GATT's Article 24 or GATS Article 5. And even more challenging would be the UK politics: the peace clause might be taken as avoiding Brexit by the back door and might well involve the UK having to continue to allow the free movement of labour for its duration. Clearly these objections may be sufficient to prevent such a scheme and so we have to accept that there could well be a period during which the UK had exited the customs union and the Single Market and yet had not secured a free trade agreement. This has come to be termed a 'hard' Brexit.

### *'Hard' Brexit*

A 'hard Brexit' entails trading with the EU27 purely on WTO terms and not bothering even to try to negotiate special arrangements. This does not seem attractive to us. As table 1 shows, The EU takes around 45% of UK exports of goods and provides around 54% of UK imports of goods. All of this trade is carried out with zero tariffs and very low non-tariff barriers courtesy of the customs union and the Single Market. If that trade were carried out on an MFN basis the EU tariff would be 5.3%<sup>10</sup>. At a more detailed level around 16% of UK exports to the EU-27 would face tariffs of more than 7%, with half of that trade comprising motor cars which would face a tariff of 10%.

It is very difficult to measure the effect of non-tariff barriers on trade volumes, but they are generally held to be high. The costs of administering the RoOs will reduce trade – in some estimates by up to 9 percent<sup>11</sup> – and differences in standards and the additional burden of certification is bound to increase this. It is not that trade will cease, but that the extra cost will discourage some trade and cut the returns to that which remains. The costs of the bureaucracy have to be found somewhere – will it come out of profits or wages?

Turning to services a hard Brexit is even harder. The data behind table 1 suggest that around a third of UK exports to the EU are of services. As noted previously, the loss of the financial passport is likely to cut exports and cause firms to relocate abroad. An overall assessment, however, is not possible without a massive research effort, because there is no uniform EU external trade policy for services. The EU's GATS schedule sets out a framework for market access which is punctuated by individual countries' derogations in particular subsectors and modes of supply. For example, while the conditions for establishing commercial presence (mode 3) in life insurance are similar across most EU members, those pertaining to the legal sector (advice on foreign law) differ widely; e.g. in France non-EU firms are not allowed to establish branches under their own name or to form partnerships with locally licensed lawyers.

It is universally accepted that dropping out of the, albeit imperfect, Single Market for services and trading under the EU's provisions for third countries will cut access

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<sup>10</sup> MFN applied tariff, unweighted average, total trade 2014, source WTO tariff profiles

<sup>11</sup> Cadestin Charles, Julien Gourdon and Przemyslaw Kowalski, 2016, Participation in Global Value Chains in Latin America: Implications for Trade and Trade Related Policy, OECD Trade Policy Papers.



considerably. Moreover, these provisions are typically more liberal than those incorporated in the EU's GATS schedule, and thus while they may be quite favourable, they could be removed at any time and thus are afflicted by considerable uncertainty that does not apply while the UK is within the EU Single Market.

### *The WTO*

- In the WTO, the obvious approach is for the UK to adopt existing EU commitments on tariffs and other trade barriers.

This may be possible through a process called rectification. This is not uncommon within the WTO and involves a member making minor technical corrections to its WTO schedule to clarify their meaning or correct mistakes. A member rectifies its schedules, informs its partners, and if there are no objections the rectified schedule becomes certified. In the case of Brexit, the rectification involves replacing 'EU' with 'UK' at the top of the tariff schedule. But if a partner does object, a renegotiation is necessary and this could become wide ranging and demanding. And once one partner has started to extract concessions through renegotiation various others will wish to do so and the process becomes a major burden<sup>12</sup>.

### *Transshipment and Global Value Chains*

Why might anyone object to a mere relabelling exercise? Possibly out of spite, but let us discount that. The real problem is that an  $x\%$  tariff levied by the UK and the EU as separate markets is not perfectly equivalent to an  $x\%$  tariff by a Single Market comprising the EU27 and the UK. Because of the customs union and the Single Market, a third country facing an  $x\%$  percent tariff on imports into the EU28 (i.e. including the UK) pays the tariff and then can circulate its goods freely around the whole union. If the UK is not part of the customs union and Single Market, on the other hand, goods cannot flow freely between the UK and the EU27; there may be tariffs to pay or inspections of standards at the border between them, which add to costs and uncertainty. For example, whereas Kenya currently exports its cut flowers to Rotterdam from where they are distributed rapidly to the UK among other places, after Brexit they may have to pay UK import duties as they enter the UK or be inspected for pests or disease. The tariff may be the same in the EU and the UK (and so it does not matter to the exporter where she pays it), but after Brexit the market separation imposes more costs on Kenyan exporters, so Kenya may challenge the rectification, arguing that its rights under the Uruguay Round are impaired and that it needs to be compensated by a tariff reduction.

The position is more complicated for intermediate goods and value chains. Imagine a case where an intermediate good is imported into Britain, incorporated into a manufactured good and then sold in Germany. It pays its  $x\%$  on the way into the UK; prior to Brexit the final good can be sold in Germany with no further questions asked, but once the markets are split the final good may no longer meet EU RoOs and so

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<sup>12</sup> WTO reports of rectification suggest that challenges are not infrequent - [https://www.wto.org/english/tratop\\_e/schedules\\_e/goods\\_schedules\\_table\\_e.htm](https://www.wto.org/english/tratop_e/schedules_e/goods_schedules_table_e.htm)



face an additional tariff on entering Germany. No tariff rate has changed but the exporter of the intermediate good is now disadvantaged.

Similarly, RoOs create concerns that value chains for EU final products could be disrupted. Final goods produced in the EU using parts and components from the UK risk losing their preferential status in the FTA partner because the UK content could no longer be counted towards EU 'local content' and thus the FTA partner's RoO is not met<sup>13</sup>.

### *Separating UK and EU Agricultural Commitments*

There are also potential problems in agriculture. Under the WTO Agreement on Agriculture, some agricultural imports from the rest of the world face tariff rate quotas (TRQs), which allow the entry of a specified quota of imports at a below-normal tariff rate. These quotas are defined at the EU level, and any division agreed between the EU27 and the UK could be challenged in the WTO as impairing the rights that others had acquired under the Uruguay Round Agreement on Agriculture. For example, suppose that a product is imported by France but not by the UK and that it pays the below-normal tariff as it enters the former. If the whole of the TRQ were assigned to the UK, France could then raise its tariff on the products to the normal level. No tariff rate would have been changed, but tariff payments would have increased. Similarly, the cap on expenditure on trade-distorting agricultural subsidies that the EU negotiated in the Uruguay Round (the so-called Amber box) needs to be divided. According to whether it goes to the UK or to Italy, it may be spent on sheep-rearing or on olives, with obviously different implications for different third parties.

Hence although the division of the TRQs and the Amber box would properly form part of the Article 50 negotiations on UK withdrawal, they would still then, in principle, have to be agreed with the WTO membership<sup>14</sup>. If the UK does not manage to do this before it leaves the EU, it could emerge with an ambiguous position despite applying exactly the same tariffs and customs procedures, possibly opening itself up to legal and diplomatic complexities and possible trade conflicts.

### *Pragmatism vs. Legalism within the WTO*

One bright side of this situation is that the WTO is a very pragmatic organisation, which does not generally trip over legal niceties. (For example, the EU commitments to the WTO have not yet been formally updated to take account of the enlargements of 2004 and 2007, and yet trade continues without challenge.) Thus the key to preventing these sorts of problems from arising, as well as those surrounding a possible EU 'peace clause' is rapid and active diplomacy with partners in the WTO and in the EU. In the WTO it might be sensible to find a sympathetic WTO

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<sup>13</sup> This point was made in the exceptionally direct *cri de coeur* made by the Japan to the EU and UK on 4<sup>th</sup> September 2016 (<http://www.mofa.go.jp/files/000185466.pdf>, page 7): "For products such as automobiles, the division of production of materials and parts is in place between the UK and the EU. Brexit would make such products unable to meet the rules of origin as EU products, which means that Japanese companies operating in the EU would not be able to enjoy the benefit of the FTAs concluded by the EU."

<sup>14</sup> See UKTPO Briefing Paper No 1, July 2016 (<https://www.sussex.ac.uk/webteam/gateway/file.php?name=briefing-paper-1.pdf&site=18>)

Ambassador to set up a discreet “friends of the UK” group to help the UK navigate the shoals.

- The UK should propose a joint approach with the EU to WTO partners

This is because the problems noted above affect the value of EU27 concessions to trading partners as much they affect the value of the UK’s. Thus the UK’s departure potentially opens the EU to demands from WTO Members to re-negotiate its schedules, so there is a shared interest in regularising relations with WTO partners as quickly as possible.

None of this should be viewed as necessarily ruling out changes to the UK’s relationships with non-EU countries, merely a way of ordering such changes in a way that allows them to be properly considered. For example, it is possible that the UK may want to reduce its level of agricultural protection and it may wish to seek deeper market access agreements for services. From the other side, developing country partners may wish to extend services talks to include Mode 4 (movement of natural persons), and developed country partners to break new ground by providing rights of establishment for foreign services providers. While all of these issues could be broached multilaterally in the WTO, with the exception of agriculture, they are more likely to be tackled in the context of bilateral or regional FTAs. It is to these that we now turn.

### **Third Country Negotiations: Setting Negotiating Priorities**

#### *Developing Countries*

The largest group within the set of third countries is the developing countries that receive unilateral preferences in the EU through the Generalised System of Preferences (GSP), including the provision of duty-free quota-free imports for nearly all goods under the Everything But Arms provisions. These are relatively simple to deal with. The GSP is a unilateral concession by the importing country and so it is entirely within the power of the UK government just to announce that it will offer exactly the same terms as the EU has on Brexit-day. This would not offer precisely the same value to developing countries as did the GSP for the EU28, but the losses would generally not be huge and might be handled ad hoc if they were pressing. The loss of value stems first from the separation of the EU and UK markets, as explained above, and second from the operation of the competitiveness clauses. These clauses require that when a developing country supplies more than 17.5 percent (14.5 percent for textiles) of the donor’s imports of a product it loses its preference. Given that the percentages would now be calculated in the UK and the EU27 separately they may disrupt certain existing trades. A third possibility is that if the UK reduces its tariffs

on other, developed, countries the preferences under the GSP are eroded. However, as we argue below, we do not see this a very strong possibility.

- We would advise that the UK government make an early announcement that it will roll over EU GSP conditions and that, over the next, say, five years, it will consider only the most egregious of harms that this may create.

This will involve a modicum of diplomacy but would create certainty for developing countries and postpone a large number of potential interactions. After five years, when the main elements of UK trade policy had been clarified, the UK should undertake a full review of its GSP provision.

### *Free Trade Agreements*

As noted above, a strict interpretation of EU treaty obligations might suggest that UK negotiations with third countries cannot begin until after Brexit. The EU might put diplomatic pressure on trading partners not to jump the gun with the UK even informally, although the signs are that British commercial diplomacy is already underway.

- For the countries with which Britain already has an FTA through its membership of the EU (including any concluded and ratified before exit), the obvious approach is to seek to continue the same conditions on a reciprocal basis for a transitional period.

Just as with the WTO and developing countries, this may still entail inconveniences for our partners, the extent of which will depend critically on what access the UK retains to the EU market<sup>15</sup>. There were 51 countries with FTAs with the EU in 2015, accounting for 14% of UK exports and 11% of imports. If instead of negotiating an FTA of some sort, the UK traded with these countries under WTO rules, UK exports would face average MFN tariffs that varied from under 5% (Israel) to almost 30% (Egypt) and perhaps, most notably, an average 17% tariff into Korea<sup>16</sup>.

Once the arrangements with the EU and the WTO are reasonably clear ('fully determined' may be too high a threshold), there are still around 20 potential new UK FTAs. These include FTAs with China, India, Brazil and various ASEAN members among rapidly growing emerging markets, as well as the USA, Australia and New Zealand among developed countries. These will need to be prioritised according to the size and diversity of the production in and markets of potential partners, the size of barriers to trade and investment, the growth of domestic demand in areas of British competitiveness, and complementarities with UK economic structures (i.e. products that could fit with UK supply chains).

The government also needs to consider how arduous the negotiations would be and how much effect marginal effort would have on the outcome. For example, Allee and Lugg (2016) show relatively formally that a negotiation with the USA largely results

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<sup>15</sup> For example, according to *The Economist* 7<sup>th</sup> October 2016, 'South Korea says its deal with the EU was based on Britain being in the single market, so it will not wish to grandfather any concessions into a bilateral agreement with Britain alone.'

<sup>16</sup> MFN applied tariff, unweighted average, total trade 2014, source WTO tariff profiles

in the partner accepting US positions on issues such a patent protection, ISDS and agriculture. This is not just a matter of relative size because we see that Japan has not managed to win many concessions in the TPP, and so statements about how well the UK will do in a negotiation, let alone how quickly agreement will be reached, are not very convincing.

Negotiating agreements with countries with the same language, where the legal system and trade objectives are broadly similar—so there are likely to fewer opportunities for misunderstandings and mistakes—is attractive. The Commonwealth is one potential source, as recent preliminary discussions between the UK and Australia underline. However, as Gasiorek (2016) points out, the Australian government has said that it intends to agree an FTA with the EU before entering one with the UK and trade in goods with Australia is quite small, so it hardly represents an alternative to the EU. The prize with Australia is in services, which account for over half of total UK goods and services exports to Australia<sup>17</sup>. But services agreements are arduous.

Another option for ease of negotiation is applying to join an existing mega-regional agreement, most notably, in violation of geography, the Trans-Pacific Partnership (TPP), subject to it being ratified/implemented by the USA. The upside of TPP is having an FTA with 12 countries including the US, Japan, Singapore, Australia, New Zealand Malaysia and Vietnam: all likely targets for the UK's independent trade policy. Essentially, however, negotiation would mean turning up for the signing ceremony. It is unlikely that any member would be interested in recasting an agreement that took more than five years to craft for the sake of UK membership.

Joining the Trans-Atlantic Trade and Investment Partnership (TTIP)—should it be signed or implemented—is another possible approach to cutting the negotiation burden. Like TPP however, TTIP would likely be a take it or leave it deal. Nonetheless, signing TTIP could, at a stroke, provide a better deal than MFN with the USA. However, the TTIP would provide only the palest imitation of the market access that the UK would receive in the EU if it remained in the Single Market. Also, since TPP and TTIP have significant regulatory provisions they would also result in an apparent loss of sovereignty and thus prompt public opposition.

## **Conclusion**

This article has laid out a sketch of the negotiating landscape that faces the UK as it implements Brexit. The priority must be to settle the UK's position with the EU and with the WTO. With the former, neither remaining in the customs union nor the Single Market seems very likely given the nature of the referendum campaign, so the best that can be hoped for is a free trade agreement with equivalent access to the Single Market in some sectors. The EEA is not a viable way of accessing the Single Market and a hard Brexit would be very painful economically. With the WTO the need is for diplomacy to try to persuade partners that they can live with the UK adopting the tariffs and other market access agreements that currently pertain through the EU. These may involve costs to those partners because the ability to ship their

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<sup>17</sup> Gasiorek <http://www.sussex.ac.uk/eu/articles/australia-trade-deal>

goods between the UK and the rest of the EU will be reduced by Brexit, but it should be manageable. Once the EU and WTO relationships are clear, it will become feasible for the UK to negotiate agreements with other countries, but even this will not be easy.